The Beacon Hill Institute

The Tax Impact of Applying the "ABC" Test to Independent Contractors

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Executive Summary

The "ABC" test represents a major effort by President Biden to reclassify independent contractors as employees. In a related matter, the president promised in his campaign to raise taxes only on those making more than $400,000. BHI found that 56% of the independent contractors most likely to be reclassified would pay more tax as employees, which we estimate to be about 7.7 million taxpayers. We estimate that 96%, or 7.5 million, of those reclassified taxpayers who would pay more tax, make less than $400,000.

After explaining how employees and independent contractors are differentially taxed, we use IRS data from a recent Treasury study to compute taxes using a carefully defined population of independent contractors, comprising four groups that are most likely to be reclassified under the new tests. We exclude independent contractors with employees, who sell a product, and who have business deductions greater than $16,409. We then compare that to a calculation of the tax paid as employees.

The most important tax variables are the amount of business deductions that independent contractors would lose as employees, the increase in the Social Security and Medicare Health Tax, and the Qualified Business Income Deduction that they would lose as employees.

Clearly, millions of independent contractors will pay more tax if forced to become employees, and almost 100% of them make less than $400,000, thus breaching President Biden's pledge.

Introduction

Individuals providing services in the United States are classified as either independent contractors (ICs) or employees. There are significant differences in the taxation of these two types of workers. Employers would normally like to classify service workers as ICs to save on employment taxes and benefit costs.[1] Service workers often prefer to be treated as ICs for various reasons and may or may not be better off from a tax perspective if they are treated as such.

The IRS has waged a long and somewhat successful battle with employers over this issue. The existing tests for IC status rest on 20 questions primarily concerning control. A worker who is subject to the will and control of the employer, not only over what work will be done but how the work is done, is considered to be an employee.[2] An IC is answerable only for the end result, not the process.

Congress is considering creating a much broader definition of independent contractor, which would result in many ICs being reclassified as employees. The Protecting the Right to Organize (PRO) Act[3] includes significant changes to the tests for IC status and would create a new standard called the "ABC" test, so named because of the three conditions that a worker must satisfy to be deemed an

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[1] As is discussed in more detail below, employers would save on Social Security and Medicare Health Insurance taxes, as well as unemployment taxes.

[2] See Reg. §31.3401(c)-1(a) as to the definition of an employee and Rev. Rul. 87-41, 1987-1 C.B. 296 for the 20 questions.

[3] H.R. 842. https://www.congress.gov/bill/117th-congress/house-bill/842/text?q=%7B%22search%22%3A%5B%22hr+842%22%5D%7D&r=1&s=8#H1ED90A2E3D3C4549AB78CEC2BEADCABB

independent contractor. It has faced severe resistance. Because passage on its own has been difficult, Democrats attempted to include it in their trillion dollar Build Back Better Act, which is a reconciliation bill requiring only a 50% vote to pass, rather than 60%.[4] This bill is in active negotiation, and the "ABC" test is not included in the bill, however their attempt to include it demonstrates their commitment to reclassifying millions of independent contractors and urgency of this issue.[5]

Specifically, the "ABC" test would make the following changes to the definition of an IC[6]:

> (b) EMPLOYEE. —Section 2(3) of the National Labor Relations Act (29 U.S.C. 152(3)) is amended by adding at the end the following: ''An individual performing any service shall be considered an employee (except as provided in the previous sentence) and not an independent contractor, unless
>
> ''(A) the individual is free from control and direction in connection with the performance of the service, both under the contract for the performance of service and in fact;
>
> ''(B) the service is performed outside the usual course of the business of the employer;

[4] H.R. 5376.

[5] The ABC test is showing up in other legislation, such as the Unemployment Insurance Modernization Act. https://www.finance.senate.gov/imo/media/doc/4.13.21%20UI%20Reform%20Discussion%20Draft%20Summary.pdf Page 3.

[6] While numerous states utilize a version of the "ABC test," only California and Massachusetts have adopted this strict form of this "ABC test". See https://crsreports.congress.gov/product/pdf/R/R46765/1. California adopted this test because of a 2018 state supreme court decision (*Dynamex Operations West, Inc. v. Superior Court*, 416 P.3d 1 (Cal. 2018). In 2019, California enacted the test into law via Assembly Bill 5 (A.B. 5) and as revised by A.B 2257, which enacted numerous exemptions.

and

''(C) the individual is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the service performed.''[7]

Item "C" is one of the most restrictive changes. An individual providing services to an organization must also provide the same services to other organizations. In other words, the IC must have more than one "client". This change would force millions of self-employed taxpayers to become employees.

Prong "B" is also problematic in that it might be impossible to define what is outside the "usual" course of business.[8]

President Biden has promised not to raise taxes for anyone who makes under $400,000 per year.[9] This raises two important research questions:

1. After reclassification, how many individuals would pay more taxes as employees than they did as independent contractors?
2. How many of the reclassified contractors who will pay more taxes, make under $400,000?

To answer these questions, we next describe the differences in taxation between ICs and employees. Then we discuss our methodology, present results, and offer some conclusions.

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[7] *Supra* at 3, note 3.
[8] https://thehill.com/opinion/finance/538505-the-pro-acts-abc-test-fails-american-workers
[9] https://www.whitehouse.gov/build-back-better/ "No one making under $400,000 will pay a penny more in taxes."

Differences in the Taxation of Independent Contractors and Employees

There are large differences in the taxation of ICs and employees, especially after the suspension until 2026 of the deduction for unreimbursed employee business expenses that were deductible as miscellaneous 2% deduction on Schedule A.[10] Table 1 presents these differences in more detail.

Table 1: Tax Differences Between Independent Contractors and Employees

	Independent Contractor	Employee
Business expenses	100% deductible	Not deductible (even if unreimbursed)
Social Security & MHI tax	15.3% of net Schedule C income up to $147,000 (2022) then 2.9%.	7.65% of gross wages up to $147,000 then 1.45%.
Qualified Business Income Deduction	20% of net Schedule C income	None
Self-employed income tax deduction	50% deduction allowed	None
Self-employed health insurance deduction	100% allowed	Employee portion of health insurance is taken out of pay pre-tax.

The crucial differences are in the deductibility of business expenses, the amount of Social Security and Medicare Health Insurance (MHI) tax paid by each, and the Qualified Business Income deduction.

Net self-employment income is gross income, usually reported on Form 1099-MISC[11], less business expenses. The Tax Cuts and Jobs Act of 2017 eliminated the

[10] *Infra* note 10.

[11] Form 1099-MISC was replaced with Form 1099-NEC starting in 2020.

deduction for unreimbursed employee business expenses from 2018 to 2025.[12] The ability to deduct these expenses is a significant advantage for ICs.

ICs pay double the rate of Social Security and MHI tax as compared to employees, but on *net* self-employment income.[13] Therefore, although the self-employment tax rate is double the rate for employees, it is applied to a smaller number due to the deductibility of business expenses.

The Qualified Business Income (QBI) deduction was created by the TCJA of 2017[14] to provide some parity for business entities that chose to operate as pass-through entities (i.e., self-employed, S-corporations, partnerships, and some rental activities), as compared to C-corporations. The tax rate for C-corporations was reduced from 35% to 21%. However, the tax rate for pass-through entities could be as high as 37% if the income was taxable to an individual. This disharmony in the taxation of business income was addressed with the enactment of §199A. Although the computation of the QBI deduction is exceedingly complex, it is generally 20% of net self-employment income.[15] This reduces the top rate on pass-through income to 29.6% (.37*.8), which is not the same as the C-corporation rate of 21%, but closer. Also, pass-through entities are not subject to double taxation, as are C-corporations. The QBI deduction is not available to employees.

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[12]. Pub L 115-97. Prior to 2018, unreimbursed employee business expenses were deductible on Schedule A (via Form 2106) as miscellaneous deductions. Miscellaneous deductions had to exceed 2% of adjusted gross income and were part of itemized deductions. Therefore, there were two limitations on their deductibility: the 2% floor and the rule that taxpayer had to have total itemized deductions in excess of their standard deduction.

[13] Independent contractors file Schedule C as part their Form 1040. They also file Schedule SE to calculate the self-employment tax, which is the equivalent of the Social Security and Medicare Health Tax for employees, but at twice the rate withheld from employee wages.

[14] S*upra*, note 10.

[15] The QBI deduction is not available to all taxpayers and contains a number of phase-outs for high income individuals, as well as several other limitations.

In addition, 50% of the self-employment tax is deductible for income tax purposes. This deduction mirrors the deduction that employers take when matching the Social Security and MHI taxes withheld from employees' wages and reduces the self-employment tax rate below 15.3%, depending on the taxpayer's marginal tax rate.[16]

Finally, self-employed taxpayers may deduct 100% of their health insurance premiums, just as an employer would be able to deduct these premiums for an employee.

It is important to note that only business deductions are deductible on Schedule C. The QBI deduction, the self-employment tax deduction, and the health insurance deduction, are not taken on Schedule C and therefore do not save self-employment tax. They are "above the line" deductions that reduce adjusted gross income and are deductible in addition to itemized deductions or the standard deduction.

Methodology and Results

To determine the tax impact of reclassifying ICs as employees we require access to IRS data on Schedule C and 1099-MISC filings. Ideally, we would recalculate the tax for a random sample considering the above tax differences. We do not have access to such detailed data. However, we can rely on research studies

[16] Net Schedule C self-employment income is adjusted by multiplying by .9235 (1-.0765) so that 50% of the SE tax is not subject to SE tax. The formula for computing the SE tax is: Net Sch. C income x .9235 x .153 up to $147,000 (2021) and then 2.9% on the amount greater than $147,000.

produced by IRS and Treasury personnel that do have access and utilize such data.[17]

We obtained mean data for a random sample, including adjusted gross income (AGI), and business expense deductions, for taxpayers who file a Schedule C and 1099-MISC (box 7).

An important issue is to define the subset of Schedule C's that are most likely to be reclassified. Not all Schedule C's will be reclassified. Self-employed businesses that sell products, or that have employees of their own, are not likely to be reclassified, even under the more restrictive "ABC" definition of IC. Furthermore, our definition assumes expense deductions under $16,409[18], and ICs who are issued a 1099-MISC with payments indicated in box 7. This definition is similar to the definition used in the Lim, et al. (2019) paper and other papers.[19]

We used the data available in Table 5 of the Lim, et al. (2019) paper. The population size is 13.81 million ICs with 1099 income, with a sample size of 1%. We do not have complete data on filing status, but we assume married filing

[17] Katherine Lim, Alicia Miller, Max Risch, Eleanor Wilking, "Independent Contractors in the U.S.: New Trends from 15 years for Administrative Tax Data", U.S. Department of the Treasury, July 2019, available at https://www.irs.gov/pub/irs-soi/19rpindcontractorinus.pdf
[18] *Id*. at page 11. About three-quarters of the broadly defined ICs have less than $10,000 in deductions.
[19] For example, see Emily Jackson, Adam Looney, Shanthi Ramnath, "The Rise of Alternative Work Arrangements: Evidence and Implications for Tax Filing and Benefit Coverage", Office of Tax Analysis, U.S. Department of the Treasury, Working Paper 114, January 2017, available at https://home.treasury.gov/system/files/131/WP-114.pdf

jointly. The Lim paper provides data for four subgroups meeting our preferred definition:

1. Primary Earner, IC secondary
2. Primary Earner, IC primary
3. Secondary Earner, IC primary
4. Secondary Earner, IC secondary.

"Primary earners" are defined as having ICs with individual labor income (1099 and W-2 wages) that is more than 50% of the household labor income. "Secondary earners" are married ICs with labor earnings less than 50% of household labor earnings. "IC primary" are ICs who earn the majority of their labor income from self-employment. "IC secondary" are ICs who earn the majority of their labor income from W-2 employment.

Table 2: Frequency Distribution of Business Deductions

# of IC's	% of Total	Total Deductions ($)
50,000	43.29%	-
17,000	14.72%	1,172
12,000	10.39%	2,344
8,750	7.58%	3,516
6,250	5.41%	4,688
5,000	4.33%	5,860
3,750	3.25%	7,033
3,500	3.03%	8,205
3,000	2.60%	9,377
2,500	2.16%	10,549
1,250	1.08%	11,721
1,000	0.87%	12,893
750	0.65%	14,065
500	0.43%	15,237
250	0.22%	16,409
	100.00%	

To accurately calculate tax differences, it is necessary to obtain a frequency distribution of expense deductions for the target sample. We interpreted the graph in Figure 3, Panel B (page 35) of the Lim paper to get a distribution of business deductions by number of filers. Because the Lim data does not include car and travel deductions, we added these deductions, which are frequently taken by our target population. Table 2 above presents this data.

Next, we compute taxes for each category of independent contractor, using all the tax differences described earlier, and compare that to the tax for an employee with the same income. We assume that both the employee and the IC take the standard deduction. We then compare the tax increase or decrease for each level of deduction and take an average percentage change across all categories of ICs. Finally, we generalize our results to the population to determine how many taxpayers will pay more or less tax, if reclassified. Table 3 presents our summary results.

Table 3: Summary Results

	Primary Earner, IC Secondary	Primary Earner, IC Primary	Secondary Earner, IC Primary	Secondary Earner, IC Secondary	Total
% of IC paying less tax if reclassified	43.29%	88.96%	0.00%	43.29%	**43.89%**
% of IC paying more tax if reclassified	56.71%	11.04%	100.00%	56.71%	**56.11%**
	100.00%	100.00%	100.00%	100.00%	**100.00%**
Number of Service Independent Contractors (1)					13,810,000
Less: Number paying less tax if reclassified					6,060,557
Number paying more tax if reclassified					**7,749,443**
% if reclassified that make under $400,000					**96.36%**
Number paying more if reclassified that make under $400,000					**7,467,264**

(1) Number of IC's meeting the definition

We estimate that 56.11% of the random sample would pay more tax if reclassified as employees. There are various ways we can estimate the number of ICs that will pay more tax if reclassified as employees. The population filing Form 1099-MISC used in the Lim (2019) study was 26 million for 2016.[20] However, that population includes taxpayers who do not fit our definition of IC and who are most likely to be reclassified. Lim refines the sample to exclude those taxpayers with deductions larger than $10,000, manufacturers, with employees, and other characteristics. After that refinement, the population is estimated at 13.81 million. Our estimate of the number paying more tax is 7.749 million.

We used 2016 data, which most likely does not include new ICs created by the growth of the "gig" economy since 2016, and certainly does not include growth due to the COVID–19 pandemic. The latest available IRS data on Schedule C filings (2018) shows about 26 million, which is about the same as 2016.[21] More recently, Freelance Forward conducted an online survey to estimate the number of freelance workers in the U.S.[22] They estimate 59 million, which, if accurate, is a dramatic increase. Using our results this would imply that about 33 million taxpayers would pay more tax if reclassified. However, their survey was limited to only 6,001 people. It is also quite possible that many survey respondents are not issued a form 1099-MISC, because they earned less than $600, and do not report their income.

Our final task is to determine how many taxpayers making less than $400,000 will pay more tax if reclassified. The mean AGI used in the data across our target

[20] *Supra*, note 15, at page 9.
[21] IRS Statistics of Income, Line-Item Estimates, 2018 available at https://www.irs.gov/pub/irs-pdf/p4801.pdf
[22] Freelance Forward 2020, Upwork, Inc., September 2020, available at https://www.upwork.com/documents/freelance-forward-2020

population was $106,759, which is far below $400,000. To get a more accurate estimate we use IRS Statistics of Income, which provides the number of Schedule Cs filed by adjusted gross income.[23] The AGI data does not include precisely $400,000, but it does include AGI from $200,000 to under $500,000 and above, so that we can easily interpolate the number of returns filed below $400,000. Using this data, we estimate that 96.36% of 7.749 million reclassified ICs paying more tax, will make less than $400,000, thus breaking President Biden's pledge.

Conclusion

The PRO Act, which was included in President Biden's Build Back Better Act, seeks to strengthen unions by various means. One provision of the PRO Act would add an "ABC" test that would reclassify service providers organized as independent contractors as employees, using a much more restrictive three-prong test. An important question is whether this reclassification would increase taxes for those reclassified. If so, this tax increase would violate President Biden's promise to not raise taxes for anyone making less than $400,000.

We conclude that this change in the definition of an independent contractor would raise taxes for 7.7 million taxpayers, almost all of whom make less than $400,000.

[23] Statistics of Income – 2018, Individual Income Tax Returns, Internal Revenue Service, Washington, D.C., Table 1.4, pages 54 and 55.

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